94-SBE-008

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	Nos. 89A-1014
PBS BUILDING SYSTEMS, INC., and	)	89A-1015
PKH BUILDING SYSTEMS, INC.	)	

Appearances:

For Appellant:	Prentiss Wilson, Jr. Attorney at Law
For Respondent:	Karl F. Munz Senior Tax Counsel

O P I N I O N

These appeals are made pursuant to section 19045[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of PBS Building Systems, Inc., and PKH Building Systems, Inc., against proposed assessments of additional franchise tax in the amounts and for the income years ended as follows:

[1/] Unless otherwise specified, all section references hereinafter appearing in the text of the opinion are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

Appellants	Income Years Ended	Proposed Assessments
PBS Building Systems, Inc.	12/31/82	$ 6,556
89A-1014	12/31/83	34,031
	12/31/84	56,314
	12/31/85	191,692
PKH Building Systems, Inc.	12/31/82	$ 31,468
89A-1015	12/31/83	89,538

The question presented for our decision in these appeals is whether the appellants were engaged in a single unitary business with each other.

Appellant PBS Building Systems, Inc., (PBS), is a California corporation which, during the appeals years, designed, manufactured, leased, and sold nonresidential, movable modular buildings. In 1967 PBS was acquired by PepsiCo., Inc., which owned it until April of 1981, when PBS's management bought it from PepsiCo through a leveraged buyout. The management group was composed of John R. Harty, PBS's president, and the two principals of the investment banking firm of Plimpton, Knox & Co. Appellant PKH Building Systems, Inc., (PKH), was formed in 1980 to be the vehicle for acquiring PBS's stock from PepsiCo.[2/] The stock purchase was completed in 1981, financed by $5.5 million of PKH's equity capital and by approximately $22 million which PBS had borrowed on a revolving credit line. Approximately half of the $22 million was used to repay advances from PepsiCo to PBS, and the other half was loaned to PKH, interest free, to directly fund PKH's purchase of PBS's stock from PepsiCo. (In November 1984 PKH refinanced its debt to PBS by issuing $22 million in notes whose repayment was guaranteed by PBS. The proceeds from the sale of the notes were then used to reduce PBS's revolving debt.) As part of the stock purchase, PKH also obtained a covenant not to compete from PepsiCo for a period of five years within the area of PBS's operation. The price of the covenant was $2,185,300, payable in installments ending April 30, 1986.

Following a buyout, Harty continued as PBS's chief executive officer and also served as PKH's chief executive and as director of both corporations. The investment bankers, Messrs. Plimpton and Knox, were the other directors of both companies, and both men entered into three-year agreements with PKH to provide management and consulting services to both PKH and PBS. PKH's activities during the appeal years consisted of holding PBS's stock, holding and making payments on the covenant not to compete, issuance of guaranteed notes (which involved the filing of a registration statement with the SEC), and the receipt of dividends from PBS which PKH used to make the payments on the covenant not to compete and, beginning in 1985, to service the debt represented by the guaranteed notes. PKH had no offices, no employees, and apparently incurred no expenses other than payments on the covenant not to compete and the debt service on the guaranteed notes.

PKH and PBS filed franchise tax returns as a single unitary business. After a field audit, the FTB determined, however, that they were not unitary with each other and recomputed their

[2/] PKH is a Delaware corporation which had its commercial domicile in California during the appeal years.

franchise tax liabilities on the basis of separate accounting. This determination led to the issuance of the deficiency assessments now before us. However, following an extensive reevaluation of its views regarding the unitary combination of holding companies and their operating subsidiaries, respondent advised us in its post-hearing brief that it now believes the appellants in this matter should be treated as having been engaged in a single unitary business.

The California Supreme Court has held that the existence of a unitary business is established by the presence of unity ownership, unity of operation as evidenced by central accounting purchasing, advertising, and management divisions; and unity of use in a centralized executive work force and general system of operation. (Butler Brothers v. McColgan, (1941) 17 Cal.2d 664, affd., 315 U.S. 501 (1942).) It has also been held that a business is unitary if the operation of the business done in California is dependent upon or contributes to the operation of the business outside California. (Edison California Store, Inc. v. McColgan, (1947) 30 Cal.2d 472 at 481.) More recently, the United States Supreme Court has emphasized that a unitary business is a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value (Container Corporation v. Franchise Tax Board, 463 U.S. 159, 178-179, rehg. den., 464 U.S. 909 (1983).)

There has been a great deal of attention focused on the "holding company issue" beginning in the late 1980's. Holding companies were a part of the Franchise Tax Board's ("FTB") effort to establish a new policy in the diverse business arena. That effort attempted to establish a new requirement ("functional integration," a term the FTB equated with "operational integration") instead of the traditional unitary tests for corporations in diverse businesses, and holding companies and their operating companies, to be considered unitary. With regard to holding companies, the FTB distinguished between "management holding companies" and "intermediate holding companies," with which it had no difficulty finding unitary with operating companies, and "passive" or "pure" holding companies, which it considered per se non-unitary with operating subsidiaries under the functional analysis.[3/] The FTB logic was as follows:

1) "functional integration" is required for a finding of unity; 2) functional integration requires "operational integration"; and 3) since passive holding companies, by definition, had no "operations" they could not be functionally integrated and therefore could not be unitary.

In the Appeal of Sierra Production Services, 5 SBE 11 (1990), we rejected this notion that our decision created a distinctly new test of "functional integration" in the diverse business context. In doing so, we reaffirmed our position that Regulation 25120 (b)(3) established a strong presumption of unity where central management and centralized departments are shown.

Today, we complete the work we begin in Sierra Production Services, with a discussion of the role of holding companies in a unitary business. We are called upon to explicitly dispel the notion that a separate unitary test exists in the holding company context. Further, there is no such separate standard or higher burden of proof which holding companies must meet in order to be held unitary with

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[3/] Analysis of the Holding Company Amendments to Regulation 25120(b) - The Unitary Business Regulations - Prepared by the Staff of the Franchise Tax Board, October, 1989 at pp. 13-20. We note that the FTB's focus has been on this third category of holding company. Since the FTB apparently has conceded that intermediate holding companies and management holding companies can be found unitary with their operating subsidiaries, our analysis shall focus on the passive or "pure" holding company.

operating subsidiaries. Contrary to respondent's position,[4/] there is no rule emanating from the decisions of this Board that pure holding companies are per se non-unitary. We set forth our reasoning below.

Appeal of Lee Mar

As far back as 1984, we clearly stated that no special test for a unitary business existed where a holding company was involved. In the Appeal of Lee Mar,, SBE, 9/12/84, the taxpayer argued that an earlier opinion of this Board, Appeal of Wm. Wrigley Jr. Co., SBE 12/15/66, compelled a finding that a holding company was per se unitary with its operating subsidiary. We stated then:

> "Nothing in that opinion [Wrigley] compels a conclusion that a holding company, by that classification or status alone, must be included as part of a unitary business with its operating subsidiary or subsidiaries . . Instead, we must now determine, pursuant to the standard tests, whether the requisite unitary relationship is present between new CSI and appellants, and that, if necessary, between old CSI and Sunbeam." (Lee Mar at p. 17.) (Emphasis added.)

We proceeded to evaluate the relationship between the holding company and operating companies involved, and found that the taxpayer had offered no evidence on several key issues, especially in establishing that the activities of the operating companies contributed to, or were dependent upon, the functions of the holding company. (Lee Mar at p. 19.) In the absence of such evidence, we decided against the taxpayer.

It is essential to note as part of our original Lee Mar decision, there is no mention of the term "functional integration." The theory was not advanced by the Franchise Tax Board when the case was originally presented; indeed, our opinion in Lee Mar pre-dated the Franchise Tax Board Audit Manual citation in footnote 4, supra, by two years, and the Proposed Amendments to the Unitary Business Regulations prepared by the staff of the Franchise Tax Board in September, 1989 by five years. Thus, our decision in Appeal of Lee Mar can in no way be said to support the FTB theory of "functional integration" in the holding company context.

Developments Since Lee Mar

[4/] "It has been the Department's practice not to include holding companies in a combined report. Only companies engaged in a unitary business or combinable. Pure holding companies, like inactive corporations, do not engage in any business activities." (Multistate Audit Technique Manual 1/86 Section 5045.)

As was pointed out at the oral argument of this case, this policy has presented a trap for the unwary and a planning opportunity for the apprised. Under this policy, a taxpayer desiring unity between an operating company and its holding company parent could electively create it by placing the officers of the operating company on the payroll of the holding company, or by placing even a modest portion of operations under the auspices of the parent holding company. Taxpayers desiring not to be unitary could maintain the classic holding company parent-operating company subsidiary relationship and enjoy per se non-unitary treatment by the FTB. This type of "elective combination" has proven to be short-sighted tax policy, and contrary to the policy goals of combined reporting and apportionment in order to prevent taxpayer manipulation.

Since our original opinion in Lee Mar, a number of significant events have transpired. In October of 1987, the Court of Appeal decided Hugo Neu-Proler International Sales Corporation v. Franchise Tax Board, (1987) 195 Cal.App.3d 326. In that case, a shell corporation created to take advantage of federal tax benefits was owned by a partnership comprised of two corporations. The court held that the corporation was not a separate entity for tax purposes, but was a part of a unitary business.

In Mole-Richardson v. Franchise Tax Board, (1990) 220 Cal.App.3d 889, the Court of Appeal rejected the FTB's argument that a special unitary requirement of "functional integration" should apply to corporations involved in diverse businesses. This case represents a clear judicial rejection of the FTB theory that different legal standards should apply to different unitary situations than those contemplated in the appropriate statutes, regulations and case law. In relevant part, the Court of Appeal stated:

> "[The FTB's] position seems to be based on the view that `functional integration' refers to a new and different concept with which a business enterprise must be evaluated to justify unitary treatment. Although the term is not specifically defined in the cases cited, a review of the analyses employed makes it clear that the determinative factors are the same a those set forth in title 18, California Code of Regulations, section 25120, as well as the earlier California cases of Butler Brothers v. McColgan, supra, affirmed 315 U.S. 501, Superior Oil Co. v. Franchise Tax Board, supra, 60 Cal.2d 406, and Honolulu Oil Corp. v. Franchise Tax Bd. (1963) 60 Cal.2d 417. Those factors are `strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing' (Cal. Code Regs., tit. 18, section 25120, sub. (b)) and `unity of ownership'; `unity of operation as evidenced by central purchasing, advertising, accounting and management divisions'; and `unity of use in its centralized executive force and general system of operation.' (Butler Brothers v. McColgan, supra, 17 Cal.2d at p. 678.)"
> (Mole-Richardson, supra, at 899.)

In summary, the FTB's "functional integration" argument, (which we noted above the FTB did not raise in Lee Mar) has been decisively rejected. The standard unitary analysis (the so-called "three unities" and "contribution and dependency" tests) is to be applied in determining whether a holding company and operating company are unitary. We reject arguments that holding companies are essentially inactive and are per se incapable of providing or receiving a flow of value to or from an operating company. Considerable unity of operation may exist, for example, by virtue of intercompany financing, including loans, loan guarantees, debt refinancing and debt reduction, and by virtue of large tax loss carryforwards owned by the holding company which are utilized by the operating subsidiary.[5/]

[5/] In two of our recent opinions, Appeal of Power-Line Sales, SBE 12/5/90, and Appeal of Insul-8, SBE 4/23/92, the taxpayers failed to prove the existence of a unitary business between a holding company and operating subsidiary. These cases do not hold that a passive holding company, even one utilized in a so-called "leveraged buy-out" of an

While explicitly rejecting the FTB's "functional integration/operational integration" theory in the holding company context, we recognize that in situations concerning corporations which are not vertically or horizontally integrated, the typical characteristics of unity may not exist (see generally Appeal of Hollywood Film Enterprises 3 SBE 664, 665 (March 31, 1982)). As we noted in the diverse business situation, the holding company context also requires to focus on the economic realities of the particular corporate structure in determining whether a holding company and its operating subsidiaries are unitary:

> ". . . (W)here there is no horizontal or vertical integration, some of the most significant unitary factors, such as intercompany product flow, often will not exist. Therefore, factors which might be considered relatively insignificant in a case of horizontal or vertical integration take on added importance because they are the only factors present to consider."

(Hollywood Film Enterprises, supra, at 665.)

Thus, where pure or passive holding companies are involved, it is relevant to carefully inquire into the nature of the benefits accruing to both the holding company and the operating subsidiaries as a result of their corporate structure. For example, even in the most extreme circumstance, where a pure holding company lacks even acquisition debt, an operating company it holds may gain significant advantages, such as insulation from liability. Consequently, in the typical case where a group of corporations conduct only one unitary business, it would be expected that the requisite contribution or dependency would exist between the "ultimate parent" holding company and its operating subsidiary or subsidiaries. It is important to recognize that flows of value or contribution and dependency may take the form of shared tax benefits (Hugo Neu-Proler), intercompany financing (loans, loan guarantees and debt retirement) or improved credit worthiness (bond security, more favorable insurance rating or interest rates on borrowed capital).

Application to the Instant Case

In the instant case, several of these factors and the flows of value they create are clearly present. PBS advanced over $11 million to PKH without interest and without security, constituting intercompany financing of substantial value to the holding company. Loans to PBS in 1981 were guaranteed by PKH, and public debt issued by PKH in 1984 was secured by the assets of PBS. Substantial amounts of money were expended by PBS on behalf of PKH for the public debt offering of

(..continued)

operating company, can never be unitary. But a close reading of Power-Line also reveals that the taxpayer failed to introduce sufficient evidence of unity. Our opinion spoke of unsupported conclusions of the taxpayer, and noted that the taxpayer did not point to the facts that would established unity. As such, Power-Line should be viewed as a failure of proof case.

Insul-8 also involved a passive holding company created to facilitate a leveraged buy-out. We also note that the taxpayer in Insul-8 failed to substantiate any of its allegations of intercompany financing, and thus it too should be more properly viewed as a failure of proof case.

PKH. The evidence also established that PKH entered into a covenant not to compete with PepsiCo, to protect PBS from competition from its former owner, a substantial benefit to PBS at the expense of PKH.

Finally, we note there was a complete overlap of officers and directors of PKH and PBS. In the context of the factors discussed previously, the complete overlap of officers and directors is further evidence of the operation of PKH and PBS as a unitary business required to file a combined return.

Thus, in our view there is substantial evidence to support a finding that PKH and PBS operated as a single unitary business that is entitled to file a combined return. Our analysis of the evidence, however, is for illustration purposes only since appellants and respondent have already agreed the deficiency assessments should be set aside.[6/]

[6/] We do not have before us today, and expressly do not decide, the issue of the treatment of a pure holding company and two subsidiaries engaged in diverse business. We do note, however, that our analysis today offers several options for resolution of such a case it is presented, including the use of Respondent's regulation 25120 (3) to apportion expenses and income of the holding company between the operating subsidiaries, or engage in a factual examination of the holding company to determine a "dominant" character for combination with one of the operating subsidiaries.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19048 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of PBS Building Systems, Inc., and PKH Building Systems, Inc., against proposed assessments of additional franchise tax in the amounts and for the income years ended as follows:

Appellants	Income Years Ended	Proposed Assessments
PBS Building Systems, Inc.	12/31/82	$ 6,556
89A-1014	12/31/83	34,031
	12/31/84	56,314
	12/31/85	191,692
PKH Building Systems, Inc.	12/31/82	$ 31,468
89A-1015	12/31/83	89,538

be and the same is hereby reversed.

Done at Sacramento, California, this 17th day of November 1994, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Fong, Ms. Scott*, and Mr. Dronenburg present.

Brad Sherman, Chairman

Matthew K. Fong, Member

Windie Scott, Member

Ernest J. Dronenburg, Jr., Member

_____, Member

*For Gray Davis, per Government Code section 7.9.

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